

THE EQUITIES CONCEPT AND ITS APPLICATION TO ACCOUNTING THEORY

BY

WALTER GERRY KELL

B.B.A., University of Michigan, 1946

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AN ABSTRACT OF A THESIS

SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR THE DEGREE OF DOCTOR OF PHILOSOPHY IN ACCOUNTANCY
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There are two theories of accounting which can be used in recording the activities of a business enterprise. One is the proprietary theory; the other is the entity theory. Under the former, the business enterprise is regarded as an association of individuals and an accounting is made only to the owners for the property they have entrusted to the business. Under the latter, the business enterprise is viewed as being separate and distinct from the parties who furnish the funds and an accounting is made to all suppliers of capital, whether they be creditors, proprietors, or stock-holders, for the property entrusted by them to the undertaking.

Both theories are capable of supporting a coordinated and consistent body of accounting theory as long as each theory is followed to its logical conclusions. However, inconsistencies and false reasoning have arisen in accounting because of the unconscious shifting from one theory to the other. The differences in viewpoint between the two theories are not reconcilable. The differences are real and not superficial for they strike directly at the function and purpose of accounting, at the exact nature of capital and income, at the form and content of financial statements, and at the relative emphasis to be placed on legal, economic, and accounting concepts.

The proprietary theory, which is the older of the two, achieved its greatest development prior to the twentieth century when the sole-proprietorship and partnership were the predominant forms of business organization in the United States. During the first two decades of the twentieth century, the corporation became the principal form of business enterprise and provided the impetus for the birth and development of the entity theory in the 1920's. Accounting theorists today can be classified into three groups; (1) those who accept the proprietary theory for all forms of business organizations and

reject the entity theory, (2) those who accept the entity theory regardless of the form of business organization and reject the proprietary theory, and (3) those who accept the proprietary theory for unincorporated enterprises and the entity theory for corporations.

The form of business organization should not affect the choice between the proprietary and entity theories. A sole proprietorship, a partnership, and a corporation actually represent different stages of development of a business enterprise. Regardless of the stage of development, the earnings of the business increase the wealth of the individual participants whether they are called proprietors, partners, or stockholders. The theoretical approach to the accounting problems of a corporation should be the same as the theoretical approach to the accounting problems of an unincorporated enterprise. It is neither necessary nor desirable to have two theories of accounting, and since each theory is capable of supporting a coordinated and consistent body of accounting theory, it can be expected that one will eventually give way to the greater reality and usefulness of the other. Thus, the first objective of this thesis is to choose between the entity and proprietary theories of accounting.

The second major objective is to explain fully the consequences of the theory selected and to apply these consequences to the development of a coordinated and consistent body of theory for the right hand side of the balance sheet. Limiting the thesis to the equities side of the balance sheet seems justified for several reasons. First, the treatment of assets is essentially the same under both theories; second, the two theories clash sharply over the treatment of equities; third, most of the inconsistencies in accounting theory are found in recording equities; and fourth, accounting for equities represents a neglected area in accounting literature.

The starting point for the evaluation and formulation of accounting theory lies in reaching agreement as to the underlying assumptions or basic concepts upon which that theory

rests. The pillars which form the foundation for accounting theory are (1) the business enterprise, (2) a going concern, (3) periodicity, and (4) accrual accounting. Each of these concepts represents an indispensable condition for theory. Without these basic concepts, accounting could not have reached its present stage of development.

Although agreement as to the basic concepts underlying accounting theory is important, this alone does not provide a sufficient basis for the evaluation and formulation of theory. This can be done only by analyzing theory in the light of the function, purpose, and unifying core of accounting. The function and purpose of accounting have evolved from one of mere record-keeping for the owner to an information service which furnishes financial data about an enterprise to all interested parties. But all parties desiring financial information may not have homogenous views. This establishes the need for a unifying core which will enable accounting to present an impartial analysis of the facts. Accounting will not progress if it yields to the pressures of any particular group at the expense of other interested parties. The unifying core is found in the preparation of published reports to fulfill the needs of creditors and absentee investors, the financial interests of the accounting entity. The financial interests are almost entirely dependent upon published reports for their financial information and they are rarely in a position to enforce their demands for accounting data.

In order for accounting to fulfill its function, an accounting must be made for all property dedicated to the undertaking. This accountability must necessarily be founded upon a concept of the business enterprise as a separate and distinct entity which is charged with this responsibility of possession and management of these properties as well as its attendant discharge relationship of fidelity and reporting to all suppliers of capital. If the success of the business venture is to be correctly ascertained, the reporting unit must be the business enterprise itself rather than the individual or individuals who administer or possess legal title to the properties. Quantita-

tively, measurable results do not rest in the individual but in the inanimate objects, rights, or privileges associated with the entity.

The underlying assumptions of the entity theory (that the entity is an operating unit wherein all transactions are viewed through the eyes of management and that owners as well as creditors can be viewed logically as "outsiders" for accounting purposes) are entirely consistent with the function of accounting and are supported by the facts of the modern business world. Under the entity theory, each accounting entity is considered to be composed basically of two elements — (1) properties, and (2) the claims attached to these same properties. Accordingly, the concept of an accounting entity is suitable for all forms of business organizations, for all sizes of undertakings ranging from a cost center within a factory to the consolidation of numerous enterprises, and for non-profit as well as profit-seeking ventures, since all property held is claimable by someone. On the basis of function, underlying assumptions, and applicability to all types of accounting entities, the entity theory must be given preference over the proprietary theory.

Acceptance of the entity theory requires the acceptance of the consequences of that theory. Capital, under the entity theory, is the total of the properties active in the business from whatever source derived. This meaning of capital favors the economic and financial aspects of capital and is entirely consistent with the basic concept of a going concern. It emphasizes the kinds and sources of capital in contrast to the generally accepted accounting definition of capital (the owner's equity in the assets of the enterprise) which stresses restrictions on withdrawals and implies a liquidation point of view for the balance sheet.

As a corollary to the entity concept of capital, there is the necessity of maintaining the distinction between contributed and accumulated capital. This distinction is important to all interested parties when making decisions regarding the busi-

ness enterprise. This distinction requires the elimination of the capital surplus account and in its place descriptive account titles which indicate the source of each item in the net worth section of the balance sheet.

Associated with the entity concept of capital is the definition of income in terms of asset changes rather than considering income as an increase or decrease in owner's equity. Accordingly, income under the entity theory may be defined as the increase in total assets resulting from the excess of proceeds recovered over the outlays advanced during the business process. This concept of income involves the matching of costs against related revenues and requires that a careful distinction be made between charges deducted from gross revenue and distributions of net revenue. From the viewpoint of the hired manager the costs are the same regardless of the financial structure of the accounting entity. Costs must be restricted to expirations of purchased assets and should not include any payments in favor of contractual or residual equities. It is the return to all long-term investors as a group rather than the return to common stockholders which reflects the success or failure of the accounting entity as an operating unit. Interest, therefore, should be considered a distribution of net income.

Another consequence of the entity theory is the distinction between capital and income. This distinction which has both practical and legal significance to all interested parties requires the separation of financial activities concerned with funds from operating activities dealing with assets and also involves the distinction between capital and revenue expenditures. The essential features of the income statement under the entity theory can be summarized as follows: (1) it must reflect all asset utilization transactions entered into for their productive effect, (2) it cannot include any elements, such as interest, related to financial transactions, (3) it is primarily historical in nature, (4) it must not over-emphasize normal recurring earnings to the exclusion of non-recurring items, and (5) it must include all corrections of prior profit

calculations. If these requirements are met, an all-inclusive income statement will result which will present all data necessary for all interested parties to judge the effectiveness of managements' administration of assets and constitute an effective aid in predicting the future earning power of the accounting entity.

Under the entity theory the income belongs to the entity until a transaction takes place which transfers the income to individual participants. During the interval between income realization by the entity and realization by the participants the latter are said to have a claim against the assets according to their contracts regarding rights in the earnings. This consequence of the entity theory is entirely reasonable and valid for all types of business organizations. The essential criterion of income realization by the individual participants lies in the receipt by them of new liquid assets for their own separate use, benefit, and disposal. For the incorporated enterprise this requires a formal transfer between the entity and the owners; a formal transaction is not necessary in the unincorporated enterprise but the relationship is identical with that in a corporation.

The entity concepts of capital and income rest inescapably on a cost basis. To the accounting entity, valuation at cost is natural and obvious. Cost is definite and results from an exchange transaction between the accounting entity and an independent party. Cost (as the price of the transaction) applies equally well to an asset acquired and a liability incurred. Actually there are three stages in accounting for costs, (1) initial recognition, measurement, and classification, (2) tracing subsequent internal movements and regroupings, and (3) final matching with revenue in the present or a future period. A departure from the cost basis in any of these stages would destroy the significance of net income as a measure of managerial skill. It is recognized that the cost basis has its limitations but it is believed that these can be best overcome by using footnotes and other means of supplementary disclosure on the financial statements and not by

incorporated "value" figures into the accounts themselves.

The final major consequence of the entity theory is the balance sheet equation: Assets equals equities. This equation divides the accounting data into two fundamental classes. For purposes of accounting, both assets and equities are tied to the concept of a business entity. The assets constitute a *direct* statement of the properties; the equities represent an *indirect* expression of the same properties, and since the same measuring unit is used on both sides of the equation, the total dollars of assets at a given date will always equal the total dollars of equities on the same date.

The concept of equities as an all-inclusive designation for liabilities and net worth was first suggested in accounting literature in 1917. The lack of wider acceptance of the concept in present accounting theory and practice rests primarily on the continuing momentum of the legal distinction between creditors and owners and on the failure to give full recognition to the similarities among these two classes of claimants for accounting purposes. An examination of the various phases of economic ownership — control, title, risk-taking, and capital furnishing — reveals that not one of these essential elements rests exclusively in any one claimant regardless of the form of business organization. Rather, these elements are found to attach in some degree to every interest. The differences among the claimants do not give rise to fundamental classes; the differences are relative and represent gradations and degrees; it is the similarities that deserve emphasis in accounting. The concept of equities is an entirely rational classification encompassing both liabilities and net worth, and the balance sheet equation (properties equals equities) is not merely a conventional arrangement but is supported by the facts of the modern day business situation.

The basis for recording equities illustrates an inconsistency in existing accounting theory and practice. Although most accountants adhere to the cost basis for recording assets, they record equities at maturity value, par value, or stated value

regardless of the actual cash price involved in the exchange. Since assets and equities are but different aspects of the same thing and since bargained-prices are the bases for the entries, consistency requires that equities be recorded at cost also.

One consequence of the entity theory which has already been discussed is the necessity for distinguishing between deductions from gross revenue and distributions of net income. This requires the separation of equities into purchased and non-purchased equities. Ordinarily the former are short-term trade creditors and the latter are long-term investors. Both types of equities supply capital, both have claims on assets, but both do not have an explicit claim on income. In acquiring commodities and personal services from short-term creditors, the transaction is clearly a purchase by the entity and a sale by the supplier which does not give the individual any claim on profits. Transactions with long-term investors, on the other hand, constitute a borrowing and lending relationship which provides the lender with an explicit claim on income. From the standpoint of the hired manager the bargained-price of the services acquired from short-term creditors (purchased equities) represents costs whereas the payments for the use of borrowed capital obtained from long-term investors (non-purchased equities) involve a distribution of net income.

Although the basic equation (assets equals equities) divides the accounting data into two fundamental classes, it is reasonable and desirable to recognize sub-classifications within each class for interpretive purposes. The classification and presentation should emphasize the economic aspects of capital and maintain the distinction between contributed and accumulated capital. This requires a classification by source and a change in the usual terminology. Accordingly, the following captions are proposed: (The familiar terminology is in parenthesis)

<i>Capital Sources</i>	<i>(Liabilities and Net Worth)</i>	
Borrowed Capital	(Liabilities)	X
Contributed Capital	(Capital Stock)	X
Accumulated Capital	(Surplus)	X
Total Capital Sources	(Total Liabilities and Net Worth)	XX

This terminology accurately portrays the balance sheet as a capital statement; kinds of capital on the left side and sources of capital on the right side. Within each category the present classification and terminology can be used except for the replacement of the capital surplus account by additional accounts with descriptive titles expressing their true nature. This basic framework can be expanded without difficulty to show important information not ordinarily disclosed in present balance sheets. Within the contributed and accumulated capital sections a subdivision can be made to show the amount legally restricted and the amount legally available for dividends.

The similarities among the equities and the definition of cost and income in terms of all long-term investors as a group raise a question about the importance to the accountant of the residual equity. It is admitted that the analytical work of the accountant, his judgments, estimates, calculations, and interpretations have a direct effect on the residual interest, but at the same time, the importance of the common stockholders claim must not be over-emphasized. The success of an enterprise as an operating unit cannot be determined and measured merely by the return to the residual equity. To regard the residual equity as the focal point of the accounting process would be a return to the proprietary theory and all of its shortcomings. In analyzing a transaction, the interpretation must be made from the standpoint of all long-term investors as a group and not from the viewpoint of the common stockholder. Proper recognition is given to the residual equity when earned surplus is reflected as a part of this equity in the

balance sheet.

The concept of equities has its limitations. The equality of assets and equities relates to totals and not to specific accounts. Furthermore, equities do not reflect all the actual rights, claims, and privileges which may be associated directly or indirectly with the properties of an accounting entity. In some instances, potential claims may far outweigh present claims but, as a practical matter, equities must be stated in terms of properties as of a given date.

The basic subject matter of accounting is the business transaction. A transaction may be defined as any happening, occurrence, process, condition, or policy which produces a change in the status of individual assets or equities. Although transactions affecting an accounting entity cannot be divided into entirely exclusive categories, they can be classified, for purposes of discussion, as either operational (profit-seeking) or financial (equity administration). The principal characteristics of financial transactions are as follows:

1. They are related to acquiring assets for productive purposes and may result from either external or internal sources.
2. They are involved in the retirement or the re-alignment of equities.
3. They are responsible for all changes in equities.

Fundamentally, there are three types of financial transactions; (1) financial acquisition transactions which cause both assets and equities to increase, (2) financial retirement transactions which cause both sides of the basic accounting equation to decrease, and (3) financial re-alignment transactions which affect individual equities but produce no changes in assets or total equities.

The principles for recording financial transactions can be summarized in the following outline.

I. Financial Acquisition Transactions

A. Recognition — Time

1. External financial acquisition transactions are given recognition in the accounts when the corporation becomes a party to binding contract.
2. The internal financial acquisition transaction is entered in the equity account at the end of the fiscal period when the net result of operations is transferred from the profit and loss account into surplus.
3. Verbal agreements require only supplementary disclosure.

B. Recognition — Amount

1. Equities, like assets, are entered at price-aggregates determined at the time the binding contract is effected.
2. Accrued amounts are found by calculation or in the corporate minutes.
3. The legal liability and the amount required in the event of reorganization, liquidation, and other special settlement are disclosed only in supplementary data.

C. Recognition — Account

1. Account Titles and Original Classification

- (a) Descriptive account titles are essential in order to disclose the true source of each item.
- (b) Classification is by source and not by contractual rights.

2. Subsequent Tracing

- (a) The original classification of equities is maintained except when:

- (1) Subsequent events cause a long-term debt to have all the characteristics of short-term borrowed capital.
- (2) Compulsory appropriations of surplus are required.
- (b) Changes in amount result from adjusting entries.

II. Financial Retirement Transactions

A. Recognition — Time

1. Financial retirement transactions are given formal recognition in the accounts at the time assets are transferred to the equity interest.

B. Recognition — Amount

1. Two amounts must be determined.
 - (a) The effective liability or carrying value of the equity retired in whole or in part and,
 - (b) the cash-equivalent of the asset or assets utilized in payment.

C. Recognition — Account

1. The account (or accounts) which reflects the retired equity is eliminated except when re-acquired securities are not cancelled.
2. New accounts such as Treasury Bonds and Treasury Stock are used when re-acquired securities are not cancelled. These new accounts are not assets but represent an off-set to the related equity accounts.
3. The differences between the carrying value of the retired equity and the retirement price represents an equity adjustment and does not result in any effective gain or loss to the entity.
4. Gains and losses resulting from market fluctuations

and call premiums are disclosed in descriptive accounts titles in the accumulated capital section of the balance sheet.

5. Gains and losses resulting from declines in enterprise value require classification in a suspense valuation account, being added to or subtracted from total resources.
6. Financial gains and losses are not disclosed in the income statement, and they do not represent deductible losses or taxable gains for income tax purposes.
7. The net financial gain appearing in accumulated capital is available for dividends to all classes of stock.

III. Financial Re-alignment Transactions

A. Recognition — Time

1. The principle established for financial acquisition transactions; i.e., when the corporation becomes a party to a binding contract applies to financial re-alignment transactions.

B. Recognition — Amount

1. Continuation Re-alignment Transactions

- (a) In transactions involving creditors, the effective liability is transferred from the old to the new account title (or titles).
- (b) In transactions with stockholders, the carrying value is eliminated from the old account and transferred to a new account or accounts.

2. Termination Re-alignment Transactions

- (a) The carrying value of the retired equity is eliminated from the accounts (financial retirement transaction).

- (b) The new equity is entered at the bargained-price or cash-equivalent of the consideration received (financial acquisition transaction).

3. Hybrid Re-alignment Transactions

- (a) When stock is donated to the corporation, the contributed capital applicable to the shares is transferred from the old accounts to a new account title which will disclose the new source of funds.

C. Recognition — Account

1. The account titles used in recording financial acquisition and financial retirement transactions serve equally well for financial re-alignment transactions; i.e., eliminate the accounts which reflect the retired equity and use descriptive account titles to record the new equity.

These principles for recording financial transactions represent a coordinated and consistent body of accounting theory for the right hand side of the balance sheet. The application of these principles in recording financial transactions will eliminate the inconsistencies which exist in present theory and practice in this area.

VITA

Walter Gerry Kell was born on December 23, 1921 in Chicago, Illinois. He graduated from Kankakee High School in 1939. In 1943 he entered the Navy and after preliminary training at Great Lakes he was chosen for the V-12 program. Under this program he attended Notre Dame University and the University of Michigan. In the summer of 1945 he was sent to the Naval Supply Depot at Bayonne, New Jersey for operational training, and shortly after V-J Day he was placed on inactive duty with the rank of Ensign in the Supply Corps. Returning to the University of Michigan, he received the degree of Bachelor of Business Administration in June, 1946, and the degree of Master of Business Administration in February, 1947. He joined the University of Illinois teaching faculty at that time, serving as an assistant in accountancy until September, 1947, when he was promoted to the rank of instructor. He held this rank until September, 1951, when he accepted a position as Assistant Professor of Accountancy at Michigan State College. In May, 1949, he passed the C.P.A. examination in Illinois, and he is licensed to practice in that state.

